

## THE BULGARIAN ECONOMY

### July 2008

#### Macroeconomic Dynamics

**The high economic activity in Bulgaria persists,** show NSI's business surveys, despite that at mid-year all four monitored sectors register slight deterioration of business climate indicators. Since May, the general business climate indicator takes a moderate downward trend. Economic conjuncture in the country remains favourable because the indicator keeps steady above its long-term average levels. In June, it is only 5.8 percentage points below the long-term maximum registered in February and March last year. Least deteriorated is business climate in industry, followed by services and construction. Most deteriorated is business climate in retail trade.

**In 2008 Q1, economic growth registers record-high levels** – according to preliminary data from NSI<sup>1</sup>, at year start total economic growth stands at 7 per cent. In 2008 Q1, growth in value added total for the economy accelerates to 7.6 per cent (against 5.6 per cent for the same period of 2007). Most contributive of acceleration is dynamics in services where growth has doubled year-on-year (from 3.6 to 8.3 per cent). At the same time, growth in industry slows down (from 10.1 to 7.7 per cent) but remains high, while growth in agriculture is down by 1.6 per cent below its 2007 Q1 level when it had moved slightly up by 0.3 per cent. As expected, we register slowdown of growth in internal consumption (growth in household consumption decelerates from 6 to 4.7 percent and in investment – from 35.9 to 15.5 per cent). Meanwhile, growth in exports of goods and services swings up (from 3.7 to 9.2 per cent) while growth in exports sinks (from 14.7 to 5.8 per cent). Accelerated real growth in total exports in Q1 is attributable only to step up of growth in exports of goods (from 2 to 11.7 per cent), while exports of services register drop by 1 per cent in real terms against growth at 11 per cent in Q1 of past year. Slowdown of growth in imports is depended by decelerated growth in imports of goods (from 15.9 to 5.1 per cent), with parallel high growth in imports of services (at about 8.5 per cent).

Record-high growth in 2008 Q1 and short-term Q2 data give us grounds to project total economic growth in 2008 Q2 at 7.5 per cent, that is to say, it will be again higher than growth a year earlier (7.3 per cent). We expect that until yearend total economic growth will still be accounted for by more moderate growth in internal demand and high growth in supply. We project growth for the year at about 7-7.5 per cent. However, it could be lower in the context of unstable international environment, delayed growth in our major partners, and if expected good yields in agriculture fail to come true.


**The current account deficit continues to deteriorate, though at a slower pace.** In the first five months of 2008, its share in GDP increases moderately (from 8.9 to 9.3 per cent of annual GDP<sup>2</sup>) but direct investments now finance the deficit at only 55.7 per cent (down from 78.1 per cent). Deteriorated current account deficit (by EUR 473 m) is attributable to growth in the balance of trade deficit (by EUR 664 m). There is also the negative effect of deteriorated balance of services (by EUR 76 m), which reverses from positive to negative, and of higher growth in deficit on

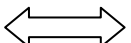
<sup>1</sup> Published on 16 June 2008.

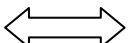
<sup>2</sup> With 2007 GDP of EUR 28 898 m and 2008 estimate of EUR 32 824 m. Source: BNB

Incomes (by EUR 10 m). In the first five months of 2008, favourable is only the contribution of the positive balance of current transfers, which moves up (by EUR 277 m).

Deteriorated trade deficit (from 9.3 to 10.3 per cent of GDP) includes also volumes attributable to increased prices of crude oil and natural gas. Over this period, deteriorated balance of services is depended by reversal of balances from positive to negative in transport services and travel. The balance of incomes remains negative year on year and its deterioration is attributable mainly to higher direct investment income payments. Improved positive balance of current transfers is depended by notable growth in transfers from the European Union to EUR 398 m against only EUR 42 m in the first five months of 2007.

 **Foreign trade remains a driver of the economy** – the ratio of trade to GDP exceeds 123 per cent. Slowdown of economic growth in the West European countries, which are major trade partners of Bulgaria, and global financial crisis have had almost no effect on trade. Overall, in nominal terms, growth in exports is higher than growth in imports (respectively 26.1 and 25.8 per cent) but for the time being this fact can hardly have any effect on the balance of trade. Balance of trade deficit (FOB/CIF) continues upward (though at a slower pace compared to a year earlier) to over 11 per cent of GDP already. This deficit poses certain risk for the economy, but at present it is not likely to decrease. The Bulgarian economy is characterized by high energy intensity and strong dependence on imported prime and raw materials and with the current market conjuncture and increasing prices growth in imports is inevitable.

 The risk posed by trade deficit is highly dependent on the structure of trade. Prime and raw materials account for the highest share in imports (35.3 per cent) which however is shrinking at the expense of energy resources whose prices drive growth in imports. The structure of imports calls for the conclusion that industrial consumption increases at a higher pace than individual consumption – growth in imports of consumer goods (22.9 per cent) is slower than growth in imports of investment goods (27 per cent). High international prices drive growth in exports of prime and raw materials, most notable here being exports of non-ferrous metals which are almost 60 per cent up year on year. Exports of investment goods exhibit a favorable trend. They increase at the average pace of total exports but register some dynamics in the shares of the different groups of machines – the share of appliances and apparatuses and of instruments and machine parts are steady up. There is also some dynamics in the geographical structure, although EU countries preserve their weight as trade partners. Shrinking European markets have made exporters shift their interest to the Balkans and Asia and exports to these countries increase at a higher pace compared to total exports. At the same time, imports from these countries decelerate. Trade with the EU exhibits a reverse trend – exports slow down slightly while imports, which are depended by the continuing investment activity in the country and increased supplies of investment goods for the developing economy, accelerate (by 32.8 per cent).

 **Bulgaria continues to attract sizable flows of foreign direct investments**, despite global financial shocks. According to BNB's preliminary estimates, in the period January – May inflow of investments to Bulgaria (EUR 1705.3 m) is smaller than in 2007, but in our opinion this is attributable to delayed reporting. By comparison, according to BNB's preliminary estimates, in the first five months of 2007 the inflow of FDI stands at EUR 1.53 b, while the currently reported value for the same period is EUR 2.02 b. Investment interest dynamics does not give us grounds to expect notable decrease in the inflow of FDI in the near future. Even the slowdown of investment in real property is not as sizeable as implied by the global financial crisis, which has broken out, and investments in equity continue upwards. This means that investors refocus on

more effective sectors, getting rid of unproductive investments and stabilizing their market positions. The high level of FDI inflow is attributable to high economic growth in the country, to economic and financial stability, and to the market potential for development of new productions and service areas, as well as to favorable business conditions, which pave the way for production activity to be redirected from other countries to Bulgaria.

**In Q2, inflation slows down** as the effect of high food prices subsides and in May and June there is, as usual, seasonal deflation. The latter has contributed for diminished effect of rising fuel prices and June saw total deflation of 0.2 per cent. The monthly dynamics of the general price index for the small consumer basket registers deflation as early as May, and June deflation at 1.3 per cent is higher than that registered by the national consumer price index, which is normally applied to measure inflation in Bulgaria. However, the harmonized index registers inflation for June. These differences in the three indexes, which are most pronounced in the second half of last year and in May and June, are attributable to the different effect of higher food price dynamics, which is due to the different weights attributed to foods in the three indexes (respectively 36.7 per cent in the big basket, 60 per cent in the small basket, and less than 24 per cent in the harmonized basket).

In the second half of 2008, we can expect growth in consumer prices, attributable mostly to more moderate dynamics of international food prices and unpredictable dynamics of fuel prices. Big and small consumer basket indices may well register deflation in August as well. We do not expect accumulated inflation at yearend (December on December) to be higher than 7-8 per cent.

NSI's June 2008 business surveys highlight services as the sector with the most optimistic expectations for absence of inflationary pressure, where 64 per cent of the respondents do not plan to change their prices in the next months. Over half of building contractors do not expect yet higher sale prices in the sector. Not more than one-fourth of respondents in industry expect higher sale prices of industrial goods. Only retail traders expect prices to go up.

**Employment coefficients improve.** According to the labor force survey, in 2008 Q1 employment of the population aged 15+ increases year on year from 47.2 to 49.7 per cent and employment of the economically active population (aged 15-64) improves from 59.7 to 62.6 per cent. Total number of persons employed in the economy, aged 15+, stands at 3289.9 (4.9 per cent up on the previous year)<sup>3</sup>. Total number of unemployed persons decreases from 272.7 thousand to 228.8 thousand and the unemployment coefficient improves from 8 to 6.5 per cent (share of unemployed persons in the economically active population aged 15+).

**Registered unemployment continues steady downward.** In May of last year, the registered unemployment coefficient drops for the first time below 8 per cent, stabilizes at levels below 7 per cent in the months from September till yearend and in June 2008 it already stands below 6 per cent. In June 2008, registered unemployment is 5.97 per cent, 1.45 percentage points down on June 2007.

**In Bulgaria, growth in productivity is higher than in the old Member States but remains unsatisfactory.** According to Eurostat's 2006 data, in Bulgaria (3.3 per cent), real growth in productivity – GDP per man-hour worked – is close to growth in productivity in Poland and Hungary but is much slower than the values of the three leaders – Lithuania (6.7 per cent),

<sup>3</sup> According to NSI data (National Accounts), in 2008 Q1 total persons employed in the economy are estimated at 3665 thousand (4.8 per cent up on the same period of 2007). More methodological details are available in NIS's site at: <http://www.nsi.bg/Gdp/Empl.htm>



Slovakia (5.4) and the Czech Republic (4.5). Growth in productivity of the Bulgarian economy registers comparatively high annual dynamics. In the past year there is slowdown in the real growth indices for GDP per man-hour worked, as well as for value added per man-hour worked. In 2008 Q1, however, we register higher growth in productivity compared to the same period of last year (respectively 3.6 and 2.5 per cent). There is slowdown in agriculture and the trend is down-running. In 2008 Q1, growth in productivity accelerates in the other two sectors – in industry it is up from 2.5 per cent in 2008 Q1 to 4.3 per cent now, and in services it improves from 1.5 to 3 per cent.

## Enterprise Policy



**No improvement in the business environment has been registered over the past period** – the percentage of managers who report that bureaucracy and corruption generate serious problems for the business remains high. Regulatory regimes are a field where no real change has been witnessed despite the Program for Better Regulation approved in early 2008. The updated Register of Regulatory Regimes is still non-operational and it is not clear yet when it will be possible to launch it. The Law on the Conflict of Interest, which was passed on first reading, will have a positive effect on the business environment. Enactment of such piece of legislation will improve the efficiency of fight against corruption by: introducing a general term for the conflict of interest, which is applicable to a maximum wide circle of persons and cases, and regulating a uniform system of legal methods for counteracting the conflict of interest.




**Public procurement remains a highly problematic area for the business.** This year, the Public Financial Inspection Agency has established again serious violations in public procurement procedures. They call for the conclusion that measures are needed to improve monitoring by public procurement contracting authorities. At end of June, the Government approved proposed amendments to the Law on Public Procurement. They are aimed at improving transparency, facilitating procedures, enhancing control and preventing irregularities. The idea is to have the bill discussed and passed by the National Assembly by the end of the summer session.




**There is lack of positive efforts to encourage entrepreneurship and the innovative development of Bulgarian enterprises.** The selection of companies to be supported with vouchers for technological development and innovations was completed in June. The funds for the scheme will be allocated from the budget of the Ministry of Economy and Energy and the amount for 2008 is almost 1 million leva. However, the program is not carefully thought out and the amount of funds is negligibly small.

**There is slowdown in the process of evaluation and approval of projects under the measure for support of innovative start up companies** of OP “Development of the Competitiveness of the Bulgarian Economy”. The procedure for submission of project proposals was launched at end 2007 and the companies to be financed were expected to be announced over the past period. A total of 104 project proposals were submitted, which the commission comprising mainly experts from BSMEPA had to evaluate and select the best ones. Because of delayed evaluation of submitted project proposals and unreasoned rejection of about 40 per cent of them still in the phase of verification of the formal compliance of proposals, the minister of economy and energy has terminated the commission. Appointment of a new commission is pending.


 **Corruption still presents serious problems** which have negative effect not only on the environment for doing business but on the whole image of Bulgaria. A World Bank report on the quality of governance says that in Bulgaria there is still much to be done as regards control of corruption and rule of law. In addition to the above two indicators the survey discusses also political stability, government effectiveness and reporting, and the performance of regulatory authorities. EC also levels serious criticism at Bulgaria for the ineffective fight against corruption. Measures to eliminate the preconditions for misuse of European funds, which are as a whole anti-corruptive in nature, were taken in April and May in response to this criticism. A vice-premier responsible for European funds was appointed and delegated powers to coordinate and control the absorption of funds from the EU pre-accession and operational programs.

However, EC's regular report on progress in Bulgaria under the Cooperation and Verification Mechanism also subjects to sharp criticism the lack of notable progress in the fight against corruption. A particularly grand problem is the ineffective control on the absorption of European funds. EC may well impose more serious sanctions for repeated failure to address and solve these problems if meaningful progress is not registered in the next months.

 **There was some development in the field of privatization in the past period.** The National Assembly passed on second reading amendments to the Privatization and Post-Privatization Control Act. The are aimed basically at updating the so-called list of companies with state interest in their capital, which are not allowed for privatization, and at lifting the ban on the privatization of medical institutions and preserving their scope of activity for a specified period after privatization, on a proposal by the Ministry of Health.

**The Parliament passed on second reading amendments to the Law on Concessions.** Major amendments address the allocation of funds from concessions of beaches – since 1 January 2009, 50 per cent of revenues from concessions of beaches will go to municipal budgets, against 30 per cent now.

## **Public Finance**

 **Budget surplus increases at a record-high pace.** May 2008 acceleration is accounted for by growth in tax revenues over the period, while account needs to be taken of the slowdown of revenues in the indirect taxes group in the first half of 2007, which is depended by Bulgaria's EU membership. Acceleration is due also to lower absorption of expenditure – in particular investment expenditure. According to Ministry of Finance data, as of May 2008 the budget balance on the consolidated fiscal program stands at BGN 3 305.5 m. At end of May, revenue accounts for 43.2 per cent of the amount budgeted for 2008. Over the reference period, expenditure stands at 33.3 per cent of the amount budgeted for 2008.

**Fiscal reserve is on an upward trend since February,** following a drop at end of past year, and stands at BGN 9.8 b at end of May 2008. It shows the same dynamics as in 2007 – moving down from November to February and then going up. This means that, at present, it is not reasonable to expect that there will be normal distribution of expenditure over the year, which would lessen their seasonal effect, and that the practice of accelerated spending at yearend will be abandoned.

**The republican budget registers surplus again.** In the first five months of 2008, the surplus stands at BGN 2.4 b. Revenues and aid amount to BGN 8 b (execution at 43.8 per cent), and expenditure, transfer and contribution to the EU budget stand at BGN 5.6 b (33.2 per cent of

budgeted amount). Tax revenues to the republican budget amount to BGN 6.9 b. Direct taxes are executed at 49 per cent, and indirect taxes – at 38.6 per cent. Indirect taxes are 27.5 per cent up on the first five months of 2007. This growth is accounted for largely by the effects that the changes in the regulatory base after our accession to the EU have on revenues from VAT in the first months of 2007. There is also the effect of the 2008 amendments to the Excise Duties and Tax Warehouses Act, which increase the excise duty rates on certain goods. Growth in revenues on May 2007 has the following breakdown by types of indirect taxes: VAT - 32.1 per cent, excise duties – 19 per cent, custom duties – 22.5 per cent. The higher amount of revenues this year is accounted for also by some bigger transactions with EU Member States, as well as by higher consumption. At end of May, the following basic commodity groups contribute for revenues from excise duties: fuels (54.6 per cent), tobacco products (36.6 per cent) and other excise goods – beer, alcoholic drinks, coffee, passenger cars, etc. As of May 2008, direct taxes stand at BGN 2.2 b, accounting for 49 per cent of the budgeted amount for 2008. This high execution is depended by the legally regulated time limits for declaring and payment of annual corporate tax. Collection rates and revenues are expected to continue upwards due to the positive effect of low tax rates, which will continue to contribute towards increased investments, improved economic activity, shrinking grey economy and increased corporate tax revenues to the budget. Corporate tax revenues stand at 60.7 of the amount budgeted for 2008. Capital expenditure is 0.3 per cent down on May 2007, at 16 per cent of the budget estimate for 2008. They register the lowest execution rate of all expenditure.

**Total government debt continues downward**, but with some slowdown over the past years. At end of May 2008, nominal government and government-guaranteed debt amounts to EUR 5.320 b. The ratio of government debt to GDP stands at 16.9 per cent at end of May, down from 19.8 per cent at end of previous year. At end of April 2008, gross foreign debt stands at EUR 30.7 b, up 42.8 per cent on April 2007. This trend of gross foreign debt dynamics is depended by increased private foreign debt (up from EUR 17.6 b at end of April 2007 to EUR 27 b at April 2008) which is accounted for by external financing of foreign-owned companies, external financing of banks, deposits by foreigners, etc.

According to World Bank's „Doing business 2008” survey, Bulgaria is the only Member State of EC-27 in world's top 10 reformers. Our country is also reforming the most in paying taxes, with corporate tax lowered from 15 to 10 per cent and social security burden down by 7 percentage points. This is illustrated best by the growth in corporate tax revenues by some 140 per cent right after the tax rate was lowered. According to the Bank, after the reform the business enjoys a more favourable investment environment and all taxpayers – higher disposable income.

## **Social and Health Policy**

**Employment increases, unemployment decreases to 6 per cent in the first half of 2008**. This is in line with the targets set out in the National Employment Action Plan. *Training and qualification programs and measures show better performance compared to previous year.* At end of Q1, almost 4 thousand unemployed persons were included in qualification courses, nearly 2.5 times up on the previous year. A new labor market initiative targets set up of labor exchanges for Bulgarians abroad.

**The „social vector” of the ruling coalition targets real growth in incomes, but specific interventions are restricted to budget sphere salaries, pensions, and benefits.** At the

negotiations on the recommended wage increase index for 2008, employers were less ready to trade off than in the previous year. Business' position on applying a differentiated index and closing the gap between low and high incomes is dictated by the growing labor force deficit and the labor cost dynamics in technology sectors. Despite income policy and collective bargaining dynamics, average wage continues upwards in the first half of 2008 to 16 per cent up on end of 2007, which shows that *the market has a potential for achieving adequate labor price levels*.

**In 2008, pensions are indexed again by a higher percentage than the one set out in the Law on the Budget of State Social Security.** Although the percentage is negligibly higher (by 1.25 percentage points), in principle, such practices generate inflationary pressure. Meanwhile, the National Social Security Institute started to prepare for update of all pensions granted by end of 2007, which will increase further pension costs by about 32 million leva per month in the last quarter of 2008. *The Government still does not propose meaningful reforms in the expenditure part of pension insurance* to ensure the necessary sustainability of pensions. There is also no progress in the regulation of the Silver Fund, which is to accumulate surpluses and targeted state allocations for the purpose.

**Unfavourable stock exchange market trends have effect on key financial results in supplementary pension insurance.** For the first time since the reform was launched, net assets of pension funds are going down.

**The ruling coalition has given concrete expression to its plans to demonopolize the health insurance fund.** The first phase will start as early as 2009 with increase of the health insurance contribution from 6 to 8 per cent and licensing of private health insurance companies. The second phase envisages partnership, and the third – direct competition of the state health insurance fund and private health insurance funds. The reform will be completed in 2010 when licensed companies will be able to receive and distribute the full amount of the contributions made by the persons insured by these companies.

In 2009, additional revenues from the higher health insurance contribution will amount to BGN 650 m. The ruling coalition has not yet defined priorities for the utilization of this resource – payment to doctors, increasing the number and value of clinical paths, expanding outpatient care, or other areas. Despite the measures for privatization of hospitals, which have been set out in the government program, the procedure is in a standstill yet.

## **Environmental Policy**

**Protection of mineral resources.** In May 2008, CoM introduced in the National Assembly a bill amending and supplementing the Law on Mineral Resources, which adds up to the objectives of the basic law of 1999. Besides the prospecting and extraction of mineral resources, the law regulates also the conditions for rational use and protection of mineral resources during extraction and treatment, and the future management of waste from the above activities.

The main objective of the bill is to transpose Directive 2006/21/EC and Directive 2004/35/EO on the management of waste from extractive industries by regulating the conditions for management of extractive waste. This is actually achieved by regulating the obligations towards holders of permits and concessionaries *for securing financially the activities for protection of the bowels of the earth and the environment*. The effective use of land by holders of permits and concessionaries for prospecting and extractive operations will be assessed on basis of the

economic significance of mineral resources and the ensuing state interest. The state interest will be applied in the requirements to, rights and obligations of concessionaries and operators of extractive waste facilities, as well as in the terms and procedure for granting permits for extractive waste management.

It has to be noted that stepping up approval of amendments to LMR and putting in place clear secondary legislation base to ensure their implementation will have a positive effect on many of the companies operating in the sector. The Bulgarian mining sector is known to bear one of the heaviest burdens of implementation of environmental legislation. Unclear government commitments for past pollution, burdensome contracting procedures for prospecting and extraction of mineral resources have kindled heated disputes between concessionary companies and the state administration. Specifying the state interests in the field and placing clear requirements to holders of permits and concessionaries will create better regulatory environment for Bulgarian companies and foreign investors and, above all, will guarantee protection of the health of people in adjacent territories and sustainable use of natural resources.

**Economic mechanisms in environmental policy.** Spending of funds accumulated from implementation of different economic mechanisms in environmental policy is subject to reassessment. The Ministry of Environment and Water (MEW) has announced its intention to change the ratio of the funds accumulated from penalties and sanctions for eco-pollution, which are commanded by the institution. The idea is half of collected funds to remain at the disposal of MEW and the other half to stay in municipal budgets. According to the ministry, the absence of a legal or another obligation allows mayors of municipalities to spend the funds for other purposes and not for ecology, and changing the distribution ratio would contribute for targeted spending of this resource.

**State product taxes** are another economic mechanism for policy implementation in the waste sector. MEW is preparing amendments to Decree No. 41/2004 on the amount of product tax and to the Ordinance on packaging and packaging waste. At present, it is up to companies to include or not the product tax in the end price of their products, regardless of whether they are members of recovery organizations, fulfil alone their obligations or pay product tax to the state. With the new amendment, the Government makes imperative the inclusion of the product tax in the end price.

Amendments are aimed at obligating companies to include the product tax in the selling price of goods. In the future, importers will have to calculate in the price of refrigerators not the “packaging” tax they actually pay (in case they pay license fees to a recovery organization) but the much higher state product tax. The state tax increase will have to be aligned with annual inflation. The legislative amendments prepared by MEW will obligate the business to collect and recover new types of material – textile, porcelain and wood, which will complement the existing list of packaging on which product tax is levied (to date, the list includes paper, plastic, glass and metal).

Previous opportunities for attaining waste recovery objectives are preserved, with one significant change – regardless of the waste recovery mechanism chosen, companies will have to include the state product taxes in the prices of their products.

Amendments are dictated by MEW’s general assessment that the systems for separate collection of packaging waste across the country are not operating effectively. Although the new requirements actually make it possible for companies to increase the prices of their products, the





business organizations are not satisfied. In their opinion, such an approach not only damages the interests of consumers, but it is also not to the benefit of companies as it will make the latter non-competitive and shrink their market.

**National participation in the European Emissions Trading Scheme (ETS).** The European Parliament and the Council of Europe suggested that Bulgaria should reduce the greenhouse gas emissions for the period 2013-2020 by 49 per cent against 1998, that is to say, in 2020; reduction will reach 37 per cent on actual 2007 emissions. Thus, the country will be allowed to emit 62 m tons of carbon dioxide annually. This quantity includes emissions from industrial installations, transport, and households. By comparison, back in 2005, industry alone exceeded the quota, emitting about 70 m tons of carbon dioxide. When the quantity is exceeded, companies will buy free allowances on the national and the European market.

These conditions are unacceptable to the Bulgarian business, in particular to the enterprises included in the National Allocation Plan. According to BIA's data, if the EC proposal takes effect, it will generate losses for the national economy at the rate of EUR 300 m per year plus significant increase in the prices of electricity and other industrial goods. There are serious concerns about losing future investments in sectors where allowances have to be allocated.

**Hard lessons have been learned from the preparation and approval of the first Allocation Plan for 2007.** The National Register of Greenhouse Gas Emission Quotas is not operational yet and many businesses are still unconvinced that investments in energy-saving technologies produce profitable positions and competitive advantages for companies. In 2007, allocated quotas were equal to verified emissions for the period. If the approach is not principally changed in drafting the plan for the next period until 2012, the main mechanisms of the European climate policy may well become a factor with adverse effect on the competitiveness of the Bulgarian industry.

Finally yet importantly, the parties concerned in the process must define their position in a clear and accurate manner and in line with the overall philosophy of the European climate policy, so as not only to protect national interests, but also to prevent country's exclusion from future Community goals.

## Financial System

**Growth in money supply, measured by broad money M3, has slowed down** by 0.4 percentage point year on year at May 2008. Growth on an annual basis is 27.3 per cent. At May 2008, contribution of quasi-money to total growth in M3 is steady upwards and the contribution of M1 decreases. The downward trend of growth in M1 is attributable to the dynamics of overnight deposits. At May 2008, in contrast to overnight deposits, growth in currency outside MFIs slightly accelerates to 2 percentage points up on May 2007. Quasi-money dynamics is depended mainly by growth in deposits redeemable at notice up to 3 months (37.2 per cent) and by growth in deposits with agreed maturity up to 2 years (33 per cent).

**Deposits continue upward**, indicating sustainable and increasing confidence of households and companies in the banking system. Contributive of monetary aggregates' dynamics are high economic growth and the inflow of foreign investments. The inflow of foreign capital in consequence of a more open national economy after country's accession to the EU in 2007 is the main driver of growth in deposits denominated in foreign currency.

**There is an upward trend of interest rates on all types of loans** extended to non-financial enterprises and households, following some slowdown in early 2008. It is attributable to higher interest rates on foreign markets – a fact that cannot but have effect on the Bulgarian lending market. Interest rates on deposits also move up over the period.

**Total banking system assets increase** at May 2008 by 38.4 per cent year on year. Growth in assets is attributable to growth in attracted funds and in banks' assets. Issued capital moves 44 per cent up year on year. In the first five months of 2008, banking system's profit is 52.1 per cent up on the same period of last year. At May 2008, the top five lending institutions account for 56.6 per cent of total banking system assets.

**At end of May 2008, total gross loans and advances stand at BGN 49.4 b.** Loans to corporate clients account for the highest (56.4 per cent) share in banks' lending portfolio in May, followed by loans to households at 30.5 per cent, including consumer loans at 16.5 per cent and housing mortgage loans at 14 per cent. Between January and March 2008, the share of bad debts is relatively stable and then goes slightly up in April and May. At end of May, the share of bad debts is 2.8 per cent, slightly up on previous months, but down 0.3 percentage point year on year. Europe is bringing strict order in our consumer loans. Under the new European Directive on Consumer Credit Loans, which took effect in June and is to be transposed in Bulgarian law by June 2010, the compensation to be paid by the client for early repayment will be cut down in the next two years and for a number of loans it will be eliminated; lenders will be required to provide detailed information; consumers will have a right of withdrawal, etc.

**Leasing market** expansion continues in 2008 Q1. At end of March, total financial and operational leasing is 85.8 per cent up year on year. Financial leasing receivables still account for a prevalent market share (98.5 per cent).

*By type of asset*, receivables on passenger car contracts account for the highest share in financial leasing and this market segment is 101.4 per cent up year on year. Next come receivables on contracts for machines, facilities and industrial equipment, which are 65.1 per cent up year on year. Third in the ranking are receivables on contracts for trucks and light trucks. Receivables on *new business* financial leasing contracts account for about one-fifth of the market segment. By type of asset, passenger cars account for the highest share in this kind of contracts (almost 35.6 per cent), 74 per cent up year on year. The breakdown of financial leasing receivables *by sectors* shows that receivables from residents account for over 99 per cent of this market segment, including 90.4 per cent from non-financial enterprises and about 8.7 per cent from households and non-profit organizations providing services to households.

Top growth register financial leasing contracts in Real Estate, Renting and Business Activities (344.7 per cent), Trade (over 145.5 per cent), Agriculture (127.3 per cent), Transport (over 120.4 per cent), Construction (over 111.6 per cent). In contrast, Hotels and Restaurants register decrease again.

## **Insurance Sector**

**Insurance market is steady up in the first quarter of 2008.** At end of 2008 Q1, income generated by insurance companies is 18.9 per cent up year on year. This percentage is higher than the rate of inflation in the country. 84.6 per cent of income is generated by general insurance and

15.4 per cent by life insurance. The amount of premiums paid is also up (32.2 per cent). In 2008 Q1, growth in premium income from life insurance is higher than growth in premium income from general insurance. Since 2006, growth in income gradually slows down in life insurance but accelerates in general insurance.

In the first three months of 2008, premium income from general insurance is about BGN 361 m, some 18 per cent up on the same period of 2007. Most contributive of growth is motor vehicle insurance which also accounts for the highest share of the general insurance market (70.4 per cent). Up 19.7 per cent is income from Third Party Liability insurance for owners and drivers of motor vehicles, which accounts for 28.2 per cent of the market. Top growth in premium income year on year registers Watercraft insurance (46.4 per cent) followed by Railway Vehicle insurance (42.6 per cent). Motor vehicle insurance tops the ranking not only in premium income but also in the share of arising claims in total arising claims (83.7 per cent). Income from Green Card insurance is notably up (by about 54 per cent), but the claims ratio remains high (143.5 per cent). It has gone down against previous periods but still indicates that premiums cannot cover compensations paid. The share of the top three companies in total income generated by the sector remains unchanged (48.6 per cent against some 49 per cent in the same period of 2007) but is up on end of 2007. This indicates slowdown of the processes of decrease of market concentration and scaling up of competition observed in the past year.

Nominal growth in the premium income of life insurance companies is 23.9 per cent. Life insurance policies and rents still account for the highest share in premium income. Income generated by this type of insurance stands at BGN 49.5 m and accounts for 75.2 per cent of the premium income generated in the sector. Accident insurance registers top growth at 47 per cent year on year. Steady up is the interest in investment-linked life insurance policies which account for a share of 7.2 per cent in life insurers' aggregated portfolio and register growth in premium income at 46.5 per cent year on year. Considering paid compensations, life insurance policies and rents again account for the highest share (76.1 per cent) and register top growth (75.9 per cent), followed by Accident insurance (65.7 per cent), whereas additional insurance decreases most (-36.7 per cent). Total growth in compensations in life insurance is 46.7 per cent. Overall, compensations are fully covered by premium income in life insurance – the claims rate is 29.3 per cent. On the life insurance market, the share of the top three companies holding the biggest market shares gradually decreases to 58.6 per cent at end of March 2008 against 63.3 per cent a year earlier. In contrast to the general insurance market, in life insurance the trend of gradual decrease of concentration and scaling up of competition in the sector persists.

In May, the Financial Supervision Commission approved amendments and supplements to two ordinances on actuarial activity and accountancy in the field.

## Capital Market

**The crisis, which swept the local capital market at end of 2007, continues for a third quarter running** without any clear indications that it will be conquered. Internationally, there are already some, though discordant, signs that the crisis is being overcome, in contrast to the local market. Besides, in 2008 Q2 we witnessed some absolutely irrational actions of investors in response to definitely positive news from certain companies. Quite certainly, had this positive news been reported about a year ago, before the crisis, the price of the respective company would




have swung up. But now participants seem not to notice and their behavior is very much the same as a couple of years ago when, overall, financial reports and disclosed information had no effect on the market price.

Lower activity of market players pushed down BSE indices by 10 per cent on average over the period and thus SOFIX fell to a new bottom level at 25 per cent below its value a year earlier. Market capitalization is also down to about BGN 21.6 b or 37 per cent of national GDP. It has to be noted that the global financial crisis, which affected other markets as well, has kept this ratio within normal limits for BSE – Sofia AD, although closer to the bottom value typical for other exchanges.




**At end of Q2, the stock exchange implemented and launched the latest version of Deutsche Börse's trading system Xetra.** To the last, no one was certain that deadlines would be met. Only at the last moment did the Financial Supervision Commission approve the trading rules of BSE – Sofia AD and thus the last barrier to system's implementation was lifted. System's launch did not bring appreciable problems for participants and for the regulated market. The short yet time of operation shows that the system works flawlessly and already provides indications that some of the functions for which it was preferred are being performed. For example, it facilitates notably the access of foreign participants who already have interconnectivity with the other markets connected in system's network, which is in line with stock exchange's objective to attract as members big investment banks. The same is true also for local investment brokers who want access to foreign markets. At the end of the quarter, Deutsche Börse announced that Bulgarian brokers would be granted facilitated access to the German market. It is the reciprocity in the treatment of participants in Xetra that is considered a serious advantage of the platform and justifies a belief that in the future the trading system will be playing greater role in local market internationalization.

## Energy Sector



**Anticipated higher prices of electricity and energy resources are a fact since 1 July 2008** (electricity appreciated by 14 per cent, heating energy – by 12.92 per cent, and natural gas – by 5.15 per cent). Companies use lower profit rates as grounds not to implement their investment plans.



**Belene NPP Project may not meet schedules** because some permits have not been issued. The Project Task Force set up and its members are suspected of lacking the capacity to coordinate, monitor and control the process of construction of Belene NPP, and of duplicating the functions of the project management. BNP Paribas has signed a contract with NEK for structuring of the nuclear loan for this strategic Bulgarian energy project. Construction of Gorna Arda Cascade is still accompanied by legal problems but implementation of this project is expected to be linked to the investor of the new nuclear power plant. The Government has discussed an option for parallel construction of unit 7 of Kozloduy NPP.

**An ordinance regulating the conditions for certification of producers of energy from RES is pending promulgation.** This should be done by the autumn of 2008. SEWRC will be authorized to issue the certificates and to build up and maintain a register of producers.

**Forthcoming is another amendment to the Energy Efficiency Act**, accompanied by set up of a new state institution for energy efficiency improvement. Experts in the sector are concerned about the fact that the state again duplicates the functions of the existing fund.

The Greek Alpha Grissin Infotech will invest some EUR 440 m in the construction of a wind farm with a capacity of 400 MW. The concession agreement between Bulgaria and Dundee Precious Metals may be reconsidered. The question is whether state interests will prevail over business interests in the Dundee Precious Metals Inc. case. Deloitte Bulgaria is the new advisor on the set up of a Bulgarian Energy Holding.

## Transport

**Global crisis triggered by jump of fuel prices affected Bulgarian carriers as well.** The upswing of oil prices and consequently of fuel prices brought serious problems for carriers, in particular in road transport. Declaring of market crisis has been requested. The main conclusion, which the ministry has come to on basis of the analysis made, is that there are not reasonably sufficient reasons to declare market crisis. The Bulgarian government did not accept the proposal to lower excise on fuel in order to support carriers.

**Bulgarian air carriers can already fly to the United States.** The U.S. Federal Aviation Administration has delivered a certificate raising Bulgaria from Category 2 to Category 1 of the U.S. International Aviation Safety Assessment (IASA) program. FAA has carried out four assessments in Bulgaria. It has established that the country complies with International Civil Aviation Organization's safety requirements and the safety category of Bulgaria's civil aviation authority in Federal Aviation Administration's (FAA) register has been raised.

**EU lifted the safeguard clauses imposed on Bulgaria in the area of aviation.** In 2007, Bulgarian cargo carriers were deprived of air certificates because their aircraft did not meet the requirements for compliance with European standards. The Ministry of Transport and Directorate General Civil Aviation Authority took a number of measures in fulfilment of safeguard clause commitments. The request for lifting of the safeguard clause was filed to the European agency. Decision to lift the safeguard clause is expected to be taken on basis of performance and at end July the request was honored.

**In 2008 Q2, the process of investment in transport infrastructure was affected by some serious shocks.** The Portuguese consortium announced to have been unable to raise funds for the construction of Trakia Highway and thus the contract for the much-discussed concession ceased to have effect. Operational programs "Transport" and "Regional Development" are blocked, and the Republican Road Infrastructure Fund has discredited itself in the eyes of EU. The National Authorising Officer responsible for the financial management of EU funds stopped the funding for ten PHARE cross-border projects managed by MRDPW where the Republican Road Infrastructure Fund is beneficiary.

The Managing Authority of OP "Transport" and Metropolitan EAD signed an operational agreement and a contract for engineering and advisory services for the design and construction of the Sofia Metro Extension Project.

## Construction and Real Estate



**In June 2008 the economic situation in construction remains favourable,** despite that the composite business climate index has dropped by 2.2 percentage points against the previous month, show NSI's data. This is attributable to more conservative managers' assessments of the current situation of building companies, with slight slowdown of activity in the sector registered on May. At the same time, expectations about sector's development in the next quarter are more restrained. Competition in the branch, appreciation of materials, unstable economic environment and shortage of qualified labor are still regarded as major constraints for the operation of businesses.



**Shadow economy is another factor with effect on construction development.** According to an expert survey, which calculates the so-called Hidden Economy Index, in construction and real property transactions are reported at less than 50 per cent of their real value. The index is calculated on basis of data from NSI, BNB, and NSSI about the amount of taxes, companies' turnover and the social security and health insurance payments for workers and employees. According to experts, judicial and legislative reform, as well as transparent management of public funds with strict control on public procurement, concessions and land substitution, are needed in order to control the grey sector.



**Building permits issued in 2008 Q1 are 20 per cent down on the last three months of 2007.** Total building permits issued since year start are slightly more than 3500. By comparison, in the last quarter of 2007, building permits issued exceeded 4600 in number. Year-on-year drop is over 13 per cent. However, there could be no saying yet of appreciable slowdown, given the large number of projects in progress which are pending placement on the market.

Overall, Bulgaria is still an attractive place for foreign investments despite the problems caused by the deficit of attractive plots and the high land prices. Sector development trends are associated with construction of modern office buildings and logistic centers at strategic locations.

**Some withdrawal of customers from the real property market is registered in 2008 Q2.**

There is slowdown in decisions to purchase property. It is provoked by absence of adequate supply, higher growth in prices, stricter financial control, growing interest rates on mortgage loans, and, above all, sounder assessment of personal income. In Sofia, property offer prices are still moving unrealistically up and now even owners of old housing property make offers at and above EUR 2000 per square meter. Varna performs slightly worse than the capital on offer prices while Plovdiv and Burgas still seem underrated against prices in the two leading cities. Despite some withdrawal of clients from the market, appreciable investments in housing property are expected in big and small towns alike. At the same time, interest towards mortgage loans does not subside. In April and May, banks extended BGN 538 m of loans for purchase of property. According to BNB's data, 67 per cent of those who have purchased housing property in 2008 have done it in these two months. Number of mortgage loans remains at record-high levels despite high real property prices.

**Since year start, there is slowdown of investment projects and withdrawal of building contractors from Black Sea and mountain resorts.** In 2008 Q1, construction along the Bulgarian Black Sea coast is down 38 per cent year on year. A supply survey conducted by the National Real Property Association (NRPA) shows that prices have not changed against the previous year. Objective reasons include higher land prices, appreciated building materials, and



the fact that supply is manifold higher than demand. Still, there are some 4 million sq. m. of holiday projects under construction and 3 m sq. m. under design.

Investors focus on a new highly promising area – spa properties. The real property market in spa resorts is emerging with first investors striving to offer competitive products. According to sector experts, supply is still disoriented and buyers' response is sporadic. According to a widely shared opinion, in the next five months there will be a boom of construction of luxury residential and hotel balneological and spa complexes.

Because of the opportunities they offer, shopping center complexes remain one of the most attractive investment projects. According to analysts, their development is expected to progress at least until 2010. Over 10 new malls are scheduled for completion and launching across the country in 2009. The higher number of mall projects has not brought about changes in the per square meter rental levels of shopping areas which vary between EUR 20 and 60 per month in towns like Sofia and Varna. Retail areas on shopping streets remain much more expensive. Top rental prices in the central part of Sofia have moved up to EUR 106 – 133 per sq. m.


**Investments under construction and future investments in the sector in Sofia total the impressive 1.5 m sq. m. of office area.** Slightly more than half of them – about 780 thousand sq. m., are under construction and scheduled for launching within two years. According to sector experts, the annual volume of newly rented offices will increase at the rate of 20 per cent. In the capital city, demand is still higher than supply, pushing up rental prices. Rental prices in Sofia move up to EUR 17 per sq. m., in the central part of Varna they vary between EUR 4 and 20 per sq. m., and in Burgas and Plovdiv – between EUR 4 and 15 per sq. m. Sale prices of office area in the big towns move within EUR 550 and 6000 per sq. m. A start has been given to the implementation of projects for construction of large class A office buildings, which in the near future will be able to satisfy demand and balance the office market.


A Bulgarian investment company plans to implement **a project for construction of eight business & industrial parks (BI parks)** in bigger towns across the country. These parks, which are innovative for Bulgaria, will be detached zones for different warehousing and logistic activities and trade in industrial goods. Excellent location, multifunctionality, good management, and high level of services will characterize BI zones. Such parks are already under construction in Bozhurishte near Sofia, in Varna, and in Plovdiv.

**The Ministry of Regional Development and Public Works and European experts suggest that Water Supply and Sewerage companies should be direct beneficiaries of finance from the European Union.** This approach will be encouraged in the new Water Supply and Sewerage Act. Upon its enactment, about 80 per cent of the assets of WSS operators will go to municipalities and the other 20 per cent will be held by the state. Local authorities are concerned that under the bill only one operator will manage the activities on a separate territory covering several neighboring municipalities. In their opinion, this centralized management may bring about closing of WSS companies.

The National Assembly took a decision to restrict the substitution of municipal for private property and the use of the purely business operation “contribution of physical assets” in the construction of certain projects. These procedures have become popular as corruption schemes. In the future, substitution and contribution of physical assets will be allowed only when two-thirds of municipal council members have voted for them. Substitution is not fully eliminated, but


## High Technology and Communications


 **The independent survey of the Internet audience in Bulgaria is already a fact** – two world-known international companies operating in the field – Nielsen Online and Gemius SA, have been working in Bulgaria for a couple of months already. For a long time, there has been demand of reliable information about the worldwide web users in the country and stronger Internet advertising in the past few years has further highlighted the need of such information. While the two companies produce somewhat different and not fully comparable results, the unbiased view certainly contributes for greater transparency of decision making in Internet advertising. To make the results of their work more visible, Gemius SA have launched the website [www.audience.bg](http://www.audience.bg) where they publish monthly information about the visit rate of sites which have chosen to be serviced by the company. To date, Nielsen Online resort mainly to the printed media to announce the results of their surveys.

 **The State Agency for Information Technology and Communications (SAITC) is preparing a National Program for Development of Broadband Internet Access.** While the program is pending introduction in the Council of Ministers for approval, its text is still unavailable for review and acquaintance with specific proposals. According to estimates submitted to the media, the provision of broadband access to the worldwide web countrywide will cost between 100 and 150 million leva.

Results of a survey conducted by Market Test in May 2008 show that *56 per cent of the active town population aged 15-55 have computers at home*. Meanwhile, *companies providing broadband Internet access in Bulgaria total 250 in number*. Data have been presented in a Bulgarian ICT cluster<sup>4</sup> survey of the condition of the Bulgarian broadband Internet market.

According to survey data, at end of 2008 Q1, *the penetration rate of broadband Internet access via LAN* is 11.8 per cent, which means that some 12 per cent of households across the country have broadband Internet access. LAN operators provide to their clients three main types of services – high-speed (broadband) Internet access, IPTV (IP television) VoIP (Internet telephone services).

 **Fourth GSM operator.** The deadline for interested persons to purchase tender documents for participation in the bidding for frequency spectrum with a range of 1800 MHz to be used for building of a fourth GSM network in the country was 27 June 2008. Eight companies bought tender documents: TransTelecom EAD, Mobil Sviat EOOD, Palladium Capital OOD, Turkcell Iletisim Hizmetleri A.S., Cosmo Bulgaria Mobile EAD, Max Telecom OOD, M-SAT AD, and Telco AG. Only one company – Telco AG has submitted a project proposal. According to experts, the result is attributable mainly to the high price – CRC announced an initial license price of BGN 38 m, bid increment of BGN 2 m, and deposit for participation of BGN 1.9 m.

 **The Electronic Governance Act took effect on 13 June.** It regulates the terms and procedure for administrative bodies' work with electronic documents, provision of electronic administrative services, and exchange of electronic documents between administrative authorities. There is still

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<sup>4</sup> [www.ictalent.bg](http://www.ictalent.bg)



no real change in the work of the administration and, unfortunately, the practice of requesting citizens and companies to produce many times information, which is principally available in the institutions, persists.

The number and value of transactions via the electronic system ePay are again up on the same period of past year. In June 2008, payments via ePay amount to almost 9.5 m leva, up 40 per cent on June 2007. People's confidence in electronic payments obviously improves, with payments via Internet prevailing notably over payments via ATMs.

## **Tourism**

**Tourism development projections** for 2008 are discordant even in the high summer season. Experts from the State Agency for Tourism (SAT) project growth in the number of foreign tourists at 7-8 per cent, depended by the fact that between January and March growth in the number of tourists visiting Bulgaria stood at 20 per cent. Meanwhile, according to hoteliers and tour operators, the start of the season does not herald good results because of withdrawal of whole tourist groups, higher fuel prices, which push up costs, stronger competition, increasing number of Bulgarian tourists heading for neighboring destinations.

**The outflow of Bulgarian tourists from national resorts appears to be a very serious problem.** The reasons are multifold – prices are high for local tour operators, improper behaviour of some hoteliers, overbuilding, pollution, poor service quality due to absence of qualified personnel. These are the main arguments for many tour operators to stop offering Black Sea holidays to Bulgarians. This confirms the absence of targeted policy for attracting Bulgarians to national resorts.



A survey conducted by experts from the Bulgarian Tourist Chamber was presented in the past period. It provides a comparatively favourable long-term outlook of tourism development. By 2013, top average annual growth at about 10 per cent can be expected in the number of tourists from Great Britain and China. Average annual growth in the number of tourists from the Balkans and Central Europe is projected at about 6 per cent. Growth in the number of tourists from Russia could be projected at 5-6 per cent annually, if the visa regime is facilitated.

A major precondition for growth in the number of Bulgarian tourists would be the complete renovation of the infrastructure. Experts from the chamber have proposed a variant of a general budget of tourism development costs until 2013. It says that some 5.8 b Euro have to be invested in tourism over the period 2007-2013. Funds should be allocated with priority for improvement of labor force qualification. Resources from European funds are to be pooled up in addition to state, municipal and private funds.

**Several programs provide opportunities for support of tourism-related activities.** First, OP “Regional Development”. A call for proposals under the measure for development of natural and cultural places of interest and adjacent infrastructure and for personnel training on promotion of these destinations was launched in May. Started were also procedures under the measure for advertisement and marketing of regional tourist sites and under the measure for national advertising. Other operational programs (Human Resources, Transport) also include options for support of tourism-related activities.



Problems with the absorption of resources from European funds are depended by lack of capacity in the small municipalities for project development and implementation – unrealistic budgets are

proposed, too high norms and rates, unreasonably high prices, absence of sustainability, shortage of financial and human resources.

**The start of the summer season confirmed that problems in tourism aggravate, in particular lack of personnel and low service culture.** Surveys show that tourists complain mainly from padded bills in catering establishments, lack of adequate personnel response to complaints, etc.

**The Strategy for Sustainable Development of Tourism has not been approved yet and is still under discussions in ministries.** This means that there is lack of clarity about sector priorities. The strategy is pending introduction in the Council of Ministers for discussion. Problems in tourism aggravate also because there are too many branch organizations (58), which do not work in harmony and do not strive to pool efforts to solve sector bottlenecks. There is lack of complete and accurate information about the number of tour operators and tourist agencies. Branch organizations insist on approval of a new Tourism Act and building of a national register specifying the exact number of legitimate tour operators and tourist agents, of categorized accommodation places and catering and entertainment establishments.

Efforts to develop alternative forms of tourism in order to attract to Bulgaria tourists with higher purchasing power are made in the past few years. Golf-tourism is increasingly in the focus of attention – there is serious investors' interest, which could bring about construction of 40 golf grounds. Bulgaria has favourable climate and the landscape is exceptionally attractive.

## Agriculture

**After the collapse of agriculture in the past year, good 2008 crop yields are expected to restore sector's positions in the economy.** Meanwhile, despite good performance since year start and higher volume of production in the agrarian sector in terms of value, 18.9 up in 2008 Q1 against the same period of last year, sector's share in GDP and GVA remains at past year levels (respectively at 3.8 and 4.7 per cent). Q2 and Q3 results are expected to improve – areas under grain have been increased (twice in some cases), the crop is very good (harvested grain is expected to exceed 5 m tons) and yields are comparatively high, which means that not only the grain balance will be secured, but the country will restore its positions of a net exporter of agricultural production. However, this would hardly contribute for appreciable decrease of prices, because of high production costs and increased global consumption. It becomes ever more obvious that if production is not optimized, productivity enhanced and the quality and quantity of production improved, agriculture will remain a sector with underused potential and inadequate share in the economy.

**The emerging upward trend of investments in agriculture instils optimism.** Investors' interest in the acquisition of farmland – another underrated asset – increases. Major factors for growth in farmland demand include low prices, increasing need of production concentration and land agglomeration; immense potential to improve the productivity and efficiency of agriculture and thus its profitability (gross operating rate); appreciable subsidies from the EU. It is investors who actualize land concentration and even build clusters in neighboring lands towards better area management (not only within a fund but also in a bigger agrarian region). First, these are the special purpose investment funds some of which get oriented to investment and direct production. Foreign investors interested in the development of uncultivated land begin to show up, relying on

their experience in the organization of efficient agricultural production and the use of European funds.

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Bulgarian agriculture badly needs technological improvement, production optimization, a wider agricultural production market, set up of real producer associations to enable better organization of crop harvesting and storage and achieve optimal prices. Much hope is pinned on the use of European funds in all places. However, the chaos in the field seems to be growing, there is total lack of clarity and great failures. Following end of May and early June inspections by the European Anti-Fraud Office (OLAF) and Directorate General for Agriculture and Rural Development of the EC on three SAPARD measures, the country was recommended to suspend payments until established weaknesses and irregularities (in the control system, above all, and in particular in the organization of tender procedures) are removed. The amount blocked exceeds BGN 200 m, and investments already made may well fail to be reimbursed.

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**Most of the measures of the Rural Development Program are not started yet because of shortage of capacity in the Paying Agency** to address beneficiaries' interest. The project proposals submitted for the first two measures have not been examined and approved yet and thus start of procedures for the other measures is delayed. Slowdown will certainly have effect on projects' implementation and the allocation of about 200 million leva may well fail to be fully absorbed. The measures, which MAF has taken, like set up of: National Agricultural Advisory Service to support development of projects for the program, Farming Agrobusiness Council to propose solutions to acute sector problems and ways to optimize the management of structural funds, a working group to develop an action plan with specific measures for overcoming weaknesses in the management of the two programs, are largely chaotic, implemented under pressure by the Commission, and fail yet to yield tangible results for producers and for agriculture.

## **Regional Policy and European Funds**

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**Problems with the absorption of EU pre-accession and structural funds have aggravated over the past period.** Irregularities and corruption have lead to partial freezing of payments under some pre-accession instruments in early 2008. Commission's report on the management of European funds was made available in the second half of July. It analyses the management of resources from pre-accession instruments, highlighting many problems in the process, and contains important conclusions, which raise serious concerns. It has been found that Bulgaria is experiencing difficulties in many of these programs and has to demonstrate that sound financial management structures are in place and operating effectively.

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
Despite that steps to improve the management of European funds have been taken over the past period (a Vice-Prime Minister responsible for the coordination of all activities and units has been appointed), all pre-accession instruments - PHARE, ISPA, and SAPARD – are concerned by irregularities or deficiencies. The main conclusion in the report is that Bulgaria needs to not only enhance substantially its administrative capacity but also drastically curb opportunities for high-level corruption and effectively fight organized crime.

Recommendations focus on the need to strengthen administrative capacity in the management of EU funds, by guaranteeing stability, training and technical expertise of staff; eliminate existing or potential networks of related persons (conflicts of interest) in the overall management of funds;


improve the supervision and transparency of public procurement procedures, at central, regional and local level in strict conformity with the applicable EU rules.

 **PHARE.** Problems with PHARE come from serious weaknesses in the management and control systems. Cases of improper spending of funds have been revealed but corrective actions have not been clearly stated. The agencies, which manage the funds, have not been able to demonstrate adequate capacity in the process. As a result, the right to manage funds has been withdrawn in respect of the Central Finance and Contracting Unit at MoF and the Phare Agency at the Ministry of Regional Development and Public Works.

**SAPARD.** Bulgaria is eligible for SAPARD funding in the amount of EUR 445 million, of which until now EUR 235 million have been paid. The report points to three sets of problems concerning SAPARD: the first relates to projects worth EUR 26 million, which are currently subject to investigations by OLAF because of suspected corruption and improper spending.


 The second set of problems concerns the activities of the ex-executive director of the SAPARD Agency for a measure having a total expenditure of EUR 10 m. Deficiencies have been revealed also in the operation of State Fund Agriculture.

The third set of problems relates to the spending of EUR 105 million still to be paid from SAPARD to beneficiaries. The audit has revealed serious irregularities in the spending of funds. Bulgaria has to urgently outline measures to remove deficiencies. Payments on this program have also been suspended until Bulgaria proves that revealed irregularities have been removed.

 **ISPA.** The report notes that many Member States have experienced difficulties with the timely implementation of ISPA and that absorption of funds is slow and difficult. However, Bulgaria is particularly slow – to date, only 18 per cent (EUR 156 m of the available funding of EUR 879 m) has been certified for projects. In December 2007, the Commission asked Bulgaria to present an action plan aimed at speeding up the successful absorption of program funds. In early 2008, conflicts of interest were suspected in the National Road Infrastructure Fund, which manages resources. These problems have lead to freezing of funds from ISPA as well.

The Government has to prepare an action plan for overcoming ISPA problems – this is very important because ISPA work is directly related to the implementation of Regional Development and Transport Operational Programs. The operation of National Road Infrastructure Fund has to be significantly improved because the structure is a beneficiary of these programs<sup>5</sup>.

The analysis of pre-accession programs is serious – it provides findings and points to facts that call for taking sound and efficient measures – something, which Bulgaria still fails to do.

 **The main conclusion in the report is** that Bulgaria needs to not only enhance substantially its administrative capacity but also drastically curb opportunities for high-level corruption and effectively fight organized crime.

According to the report, urgent action is needed because deadlines for contracting some of the funds are approaching, after which the funds will be lost to Bulgaria. Bulgaria needs to:

- Strengthen administrative capacity in the management of EU funds, by guaranteeing stability, improving the qualification and technical expertise of the staff in the respective

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<sup>5</sup> A decision to transform the fund into a state agency was taken in the second half of July.

units. **Experts** need to be appointed in these structures in a way which does not generate any opportunities whatsoever for conflicts of interest.

- Eliminate existing or potential networks of related persons (conflict of interest) in the overall management of funds.
- Improve the process of monitoring and transparency of public procurement at central, regional and local level, in strict compliance with rules applied across the EU.
- Increase control of the legality and regularity of expenditure by conducting audits on its own and across all funding programs.
- Ensure that EU funding is well protected. Immediate response by supervisory bodies is needed in case of suspected misuse or corruption.
- Report without delay to the Commission on irregularities or misspending of funds – whether confirmed or suspected. Clear definitions of irregularities and of procedures and measures to be taken for their removal.
- Take protective, corrective or disciplinary measures swiftly where necessary, and informing the Commission accordingly.
- Improving co-ordination between ministries, between the various structures involved in the process of absorption of funds, at central, regional and local level.

The Commission will assist Bulgaria in improving its actions in respect of the operation of funds. It calls on Member States to also assist Bulgaria.

After all, the Government and the Bulgarians themselves have to take important steps to improve the administrative capacity, to conquer corruption and organized crime, so that the country can perform its tasks and absorb earmarked funds.